

# Plan for Jobs Today and Jobs Tomorrow

## Fiscal Year 2006 Executive Budget

As in the past, Governor Granholm's budget reflects the priorities of the citizens of Michigan. Throughout the last two years, the Governor has engaged the great citizens of the state in a dialogue about the services government should provide. Michigan citizens believe that our government must be fiscally responsible while both protecting our quality of life and growing our economy. In fact, the Governor believes the economy cannot grow without a strong quality of life. This budget is structurally sound and maintains the balance between economic growth and quality of life.

Two days ago, the Governor delivered her third State of the State address. She emphasized the importance of maintaining that balance. *"Like the two that came before it, my budget will protect the things that matter most to our citizens, while finding efficiencies and reducing costs. And like others before it, it will advance tough, tough choices to make ends meet."*

The theme of the Governor's State of the State address is captured by the phrase "Jobs Today – Jobs Tomorrow." The budget recommendation presented to you today reflects these job growth priorities. The proposal accelerates new capital infrastructure projects to stimulate the economy with good construction jobs now, while supporting sustained growth in the future. The budget also includes \$10 million in new funding to invest in the Michigan Opportunity Partnership to train unemployed workers for healthcare and skilled trades jobs that are available now and will be available in the future in large numbers. The Governor's budget also includes \$200 million in spending for the Michigan 21<sup>st</sup> Century Jobs Initiative which will invest \$2 billion to develop new products and technology-based businesses and jobs in Michigan.

In the face of declining federal assistance, increasing Medicaid caseloads and lackluster revenue growth, the budget challenges we face today remain serious. To address this difficult task, Governor Granholm reformed the budget process to focus spending on providing services that matter most to citizens. As a result, the Governor's proposal increases funding for K-12 education, protects funding for public safety and health care, provides funding for job-creation

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*"Our employers and our families want the same things – good schools, affordable health care, public safety, and a strong business climate. In the New Economy, a competitive business climate and a great place to live and raise a family go hand-in-glove."*

**Governor Granholm, January 27, 2005**

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initiatives, reforms the state purchasing system and implements administrative efficiencies throughout state government. Our budget prioritizes both expenditures and tax subsidies to focus spending on those activities that deliver results that matter most to the public.

This budget focuses on state spending in six priority areas – Education, the Economy, Health and Human Services, Hometown Security, the Environment and Better Government – and justifies every expenditure and every tax subsidy – to ensure that we spend every penny wisely. The Governor's budget provides the balance we

need to build a better Michigan. The budget reflects many difficult choices, including \$390 million in spending reductions. Despite the significant cuts, the proposal protects those things that make Michigan a great place to live – the schools where our children learn and grow, the clinics and hospitals that provide our health care, and police officers and fire fighters who keep our communities safe. It accomplishes all of this, while at the same time creating jobs and keeping our tax structure competitive.

## Fiscal Outlook

Michigan's economy continues to lag behind the national economic recovery, primarily because our economy needs greater diversification. While our unemployment rate is high, historical trends show that the current rate is better than our unemployment rate coming out of previous recessions. Right now, the state's unemployment rate is 1.3 percent above the national average. In the 1990-1991 recession, the state's unemployment rate peaked at 9.3 percent, 2.5 percentage points above the national average. In the 1980-1982 recession, the state's unemployment rate topped-out at 15.5 percent, which was 5.8 percentage points above the national average.

Governor Granholm believes that while no state government is solely capable of turning an economy around, Michigan needs a robust business climate to attract new business and keep jobs here. To this end, the Governor has proposed the largest business tax restructuring reform package in over three decades. The Michigan Jobs and Investment Act will encourage existing major employers to continue to keep jobs in Michigan, help small businesses grow, and encourage research and development companies to create new high-growth jobs in this state. This tax restructuring, combined with the Governor's "Jobs Today – Jobs Tomorrow" plan and her commitment to protect our quality of life, will grow Michigan's economy and secure its future.

Another factor in Michigan's economic struggles is the strain federal policies continue to place on our budget. These policies will place a \$356 million burden on our budget in fiscal year 2006. In addition, Michigan continues its tradition as a 'donor state.' According to the Tax Foundation, in 2003, Michigan received only 86 cents back for every dollar it sent to Washington. In contrast, for every dollar New Mexico sends to the federal government, they get almost \$2 back.<sup>1</sup> Governor Granholm, working in concert with our Congressional delegation, will continue the fight to help bring back our fair share from the federal government.

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*"When Granholm took office two years ago, she inherited a state heavily in debt and losing manufacturing jobs by the thousands. Her proposal to cut the SBT tax by 37 percent is a remedy that makes good sense... The proposal is a remedy worth supporting."*

**The Macomb Daily, February 1, 2005**

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<sup>1</sup> Federal Tax and Expenditures by State, The Tax Foundation, December, 2004

The recently released study by the National Conference of State Legislatures (NCSL) tells us that Michigan is not alone in its fiscal difficulties. The same NCSL study shows that 23 states are reporting spending overruns for some portion of their 2005 budget and 22 states will experience budget problems in 2006. Sixteen states report that Medicaid spending will exceed appropriations for the current fiscal year.<sup>2</sup>

Estimated Shortfalls	
California	\$6.7 billion
Connecticut	\$600 million - \$1 billion
Illinois	\$1.4 billion
Indiana	\$400 million - \$1 billion
Iowa	\$231 million
Massachusetts	\$300 - \$800 million
Minnesota	\$485 - \$700 million
New Jersey	\$4 billion
New York	\$3 - \$6 billion
North Carolina	\$1.1 billion
Ohio	\$1.4 - \$2 billion
Wisconsin	\$810 to \$940 million

A December 2004 study by the Center on Budget Policy and Priorities confirms that at least 22 states are now projecting budget shortfalls in their 2006 budgets. These shortfalls average about 6 to 7.5 percent of their general fund spending.<sup>3</sup> The chart on the left depicts the troubles facing many of the larger states, as well as our neighboring states.

## Revenues

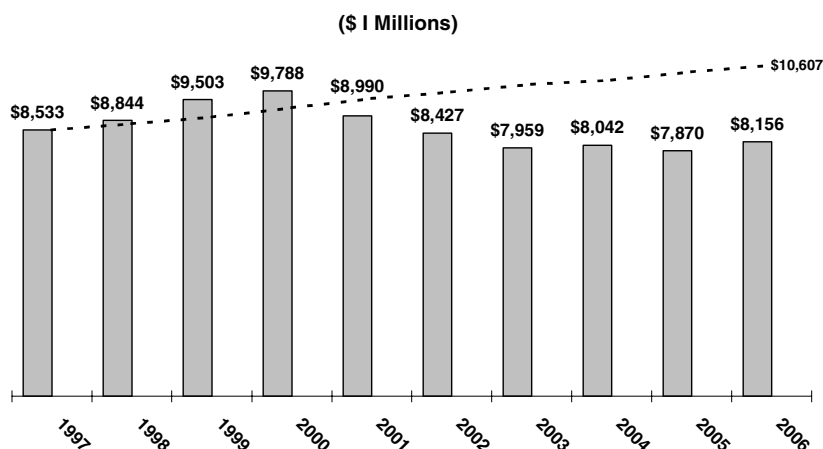
State law requires two revenue estimating conferences per year. The conferees include the State Treasurer and the directors of the House and Senate fiscal agencies. The conferees agree upon baseline revenue estimates for the current year and the upcoming fiscal year, for both the general fund and the School Aid Fund. The conferences are held in mid-January and mid-May. The January conference provides the estimates upon which the Governor's budget recommendation is based. The May conference provides an opportunity to review the January estimates before final legislative action on the budget. In addition, the conferees can convene a special revenue estimating conference at any time.

The 2006 baseline general fund revenues are estimated at \$8.16 billion, \$1.6 billion less than actual fiscal year 2000 revenues.

General fund revenues are less than they were in 1997 and \$2.4 billion below where they would be if revenues had grown at the rate of inflation.

Fiscal year 2006 School Aid Fund revenues are estimated at \$11.3 billion, an increase of \$422 million from the revised 2005 estimates, but only \$340 million more than the 2005 enacted budget.

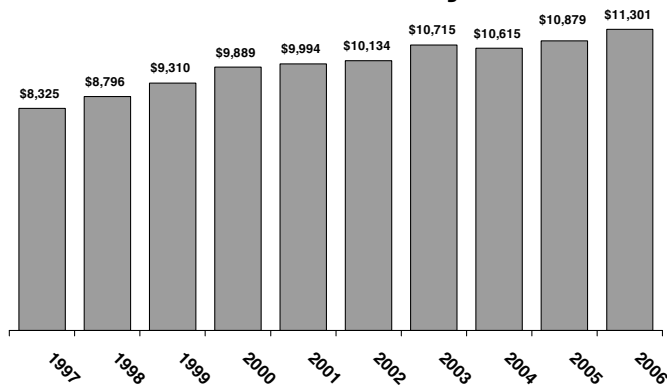
### General Fund Revenues are Below the Rate of Inflation and Less Than They Were in 1997



<sup>2</sup> State Budget Update; National Council of State Legislatures, November 2004

<sup>3</sup> State Fiscal Crisis Lingers; Cuts Still Loom, Center on Budget Policy and Priorities, December 8, 2004

## School Aid Fund Revenues Grow Steadiy



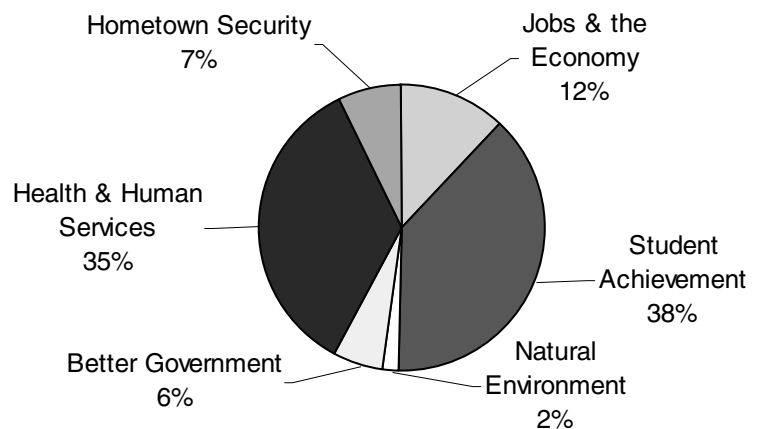
To help put today's revenue situation in perspective, in 1997, School Aid revenues were \$8.3 billion, or \$200 million less than the general fund. While general fund revenues have *declined* by \$377 million since 1997, School Aid revenues have *increased* by almost \$3 billion. The School Aid Fund revenues have performed much better than general fund revenues for two primary reasons -- the School Aid Fund was protected from tax cuts enacted in the late 1990's; and the broad based mix of school revenues are less susceptible to economic downturns.

## FISCAL YEAR 2006

Governor Granholm's 2006 budget was developed using a "budgeting for outcomes" process. The process protects and enhances those priorities that matter most to the people of Michigan by focusing the state's financial resources in these areas. The spending priorities in this budget are tied to six overarching goals, with related strategies and indicators of success. The budget detail includes spending totals for each activity consistent with the new process. Also included is detail in a format that complies with existing Constitutional and statutory requirements, including the earmarking of revenues to funds as required by law. The budget uses the general fund and School Aid Fund revenue estimates agreed to in the January Revenue Estimating Conference.

The overall budget proposed by Governor Granholm totals \$41.2 billion. The recommendation includes \$15.7 billion for Education, \$14.5 billion for Health and Human Services, \$5.0 billion to improve the Economy, \$680 million for the Environment, \$2.9 billion for Hometown Security and \$2.4 billion for Better Government. The recommendation spends \$11.4 billion from the School Aid Fund and \$8.9 billion from the general fund. The budget dedicates \$1.1 billion for revenue sharing payments to local units of government, and \$3.4 billion for transportation needs.

## FY 2006 Total Spending



## Budget Reflects Priorities

The spending priorities in this budget were achieved through the new budgeting for outcomes process and are based on the input the Governor received from the citizens of the state. Through the new process, six workgroups were formed and charged with developing goals and strategies to meet those goals. Each and every activity funded in the state's budget was assigned to one of these six goals.

The Governor's budget is based on her belief that, in order to build a better Michigan, we must educate our children; protect our families; and secure Michigan's future. Michigan's six goals are essential in achieving these objectives. Some highlights of Governor Granholm's budget are detailed below, including the desired results from the identified spending.

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*"Our goal is to ensure that citizens get every penny of value out of every one of their tax dollars. We can do nothing less than provide the services citizens most want in the most efficient way possible."*

**Governor Granholm, January 31, 2005**

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### STATE OF MICHIGAN GOALS

<b>Education:</b>	<i>Improve Student Achievement</i>
<b>The Economy:</b>	<i>Sustain and Create Business Investment and Jobs in Michigan</i>
<b>Health And Human Services:</b>	<i>Make Michigan's People Healthier and Our Families Stronger</i>
<b>Hometown Security:</b>	<i>Protect Our Citizens and Make Michigan's Communities Safer</i>
<b>The Environment:</b>	<i>Enhance the Quality of Michigan's Natural Environment</i>
<b>Better Government:</b>	<i>Make Government in Michigan More Cost Effective and Efficient</i>

#### *Improve student achievement*

- The per-student foundation allowance is increased by \$175 per student, with an additional \$50 for each high school student. Funding for academically at-risk students is also increased by \$33 million.
- Funding for higher education institutions is enhanced by providing an extra \$100 million, available in both 2005 and 2006, for special maintenance needs to enable colleges and universities to improve laboratory space, libraries, classrooms, and other critical infrastructure needs. This increase is offset by a \$30 million reduction in college and university discretionary funds in both years.

### *Sustain and create business investment and Jobs in Michigan*

- The budget includes \$716 million in capital infrastructure proposals, a \$200 million investment in the Michigan 21st Century Jobs Initiative, and \$10 million for the new Michigan Opportunity Partnership.

### *Make Michigan's people healthier and our families stronger*

- The budget protects health care and public assistance benefits for our most vulnerable citizens. A record number of 1.4 million people, including 840,000 children, receive medical coverage under the Medicaid program. Over one million people each month, primarily families with children, receive cash assistance and food assistance.

### *Make government in Michigan more cost effective and efficient*

- The budget reflects \$13.5 million in administrative efficiencies and \$30 million in contract savings. The budget also reforms the state contracting process, continues consolidation of human resources functions, and uses technology to provide faster service.

### *Protect our citizens and make Michigan's communities safer*

- The budget maintains the security of our prison system while reducing the need for 1,300 prison beds with a mix of policy changes, spending reductions, lease cancellations, and administrative efficiencies.
- The budget maintains the state's forensic lab services and current State trooper levels, while reducing administrative overhead in the Department of State Police.

### *Enhance the quality of Michigan's natural environment*

- The budget maintains funding for the operations of Michigan's 97 parks; preserves funding for critical environmental protection programs; increases funding for the on-line environmental permitting system; and continues efforts to eradicate the Emerald Ash Borer infestation.

## Funding Gap

In developing the fiscal year 2006 budget recommendation, the Governor had to address the structural imbalance in the general fund. The funding gap in the 2006 general fund budget is estimated at \$773 million. The funding gap is the difference between available revenues and what it would cost to continue to provide services at current levels.

Fiscal Year 2006 General Fund Revenues	
Consensus Revenues	\$8,156.2
Revenue Sharing Freeze	396.1
Suspend County Revenue Sharing	182.3
Continue other FY05 Revenue Adjustments	30.0
<b>TOTAL FY06 REVENUE ESTIMATE</b>	<b>\$8,764.6</b>

Addressing this gap required a thorough review of all activities in state government, as well as a review of the costs of each activity. It also required an intense review of existing tax expenditures and tax subsidies. The budget development process weighed each activity, each tax expenditure, and each tax subsidy against these six goals. Those expenditures that did not match the citizens highest priorities were reduced or cut altogether.

<b>Fiscal Year 2006 General Fund</b>	
FY05 Enacted Appropriations	\$8,699.5
Baseline Spending Adjustments	
Loss of federal special financing revenue	161.2
Medicaid caseload & utilization	214.3
Tobacco tax fund shift from MBTF to GF	119.5
Medicaid – lost Merit Award funds	60.4
Corrections bed space needs	55.6
Debt service	46.4
FIA caseloads	11.3
Restore FY05 employee concessions	76.3
Employee benefit cost increases	80.8
Other	11.9
<u>Subtotal Baseline Spending Adjustments</u>	<u>837.7</u>
<b>TOTAL BASELINE SPENDING ESTIMATE</b>	<b>\$9,537.2</b>
<b>TOTAL REVENUE ESTIMATE</b>	<b>\$8,764.6</b>
<b>TOTAL FUNDING GAP</b>	<b>\$772.6</b>

## Closing the Funding Gap

Since taking office in January 2003, Governor Granholm has faced a prolonged budget crisis. The Governor's first fiscal challenge was a \$350 million combined general fund and School Aid Fund shortfall that she inherited in the 2003 budget. Even more daunting was the \$2 billion structural deficit that continued in the 2004 fiscal year. In each year the Governor and the legislature worked together in a bipartisan fashion to bring the budgets into balance.

Unfortunately the fiscal challenges continued. In 2004, and again in 2005, the actual revenue collections continued to lag behind the revenue estimates. Adding to the budget shortfall were skyrocketing Medicaid costs caused by ever increasing caseloads and changes in federal policies. Each of those budget years had to accommodate for the loss of general fund revenue from phased in tax cuts approved in 1999 and 2000.

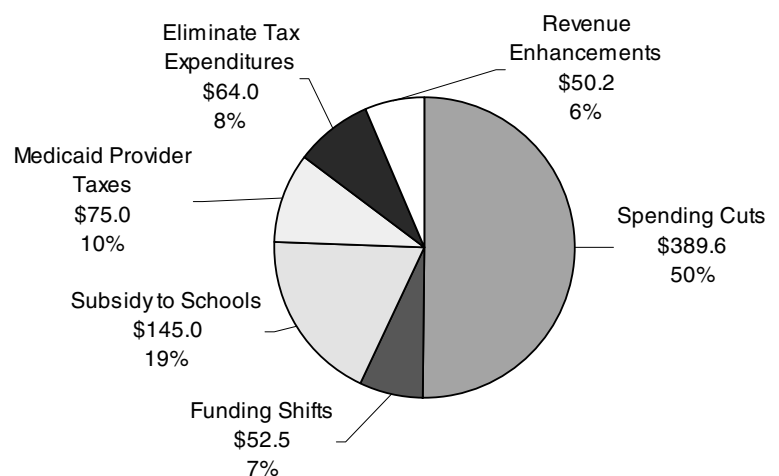
The Governor is committed to addressing the on-going structural budget shortfall by fostering economic growth and job creation in Michigan. Budget cuts that undermine our quality of life, or tax increases that compromise our economic competitiveness, only make it more difficult to achieve that goal. Instead, the Governor is taking a balanced approach that cuts spending where possible and focuses the states resources on the key activities that will retain and create jobs in Michigan.

The Governor's budget closes the \$773 million general fund gap with an appropriate blend of solutions. After ranking each government activity against Michigan's goals, the Governor recommends the elimination of funding for low priority activities. She also reduces spending throughout state government by challenging managers to achieve the same, or better, results with less money. For example, ongoing reforms of the state's purchasing system will save \$30 million in fiscal year 2006. In total, spending reductions account for over half of the solutions to address the funding gap.

Over 80 percent of general fund spending is concentrated in four areas: Higher Education, Community Health, Corrections, and the Family Independence Agency. Likewise, over 80 percent of the spending reductions are concentrated in those four areas. The budget includes a proposal to reform the state Medicaid system, which will save \$78 million in fiscal year 2006; and a 4 percent Medicaid provider rate reduction, which will save \$61 million. The budget also includes \$55 million in reductions in the Corrections system, including a multi-faceted initiative to control prison growth, which will save over \$26 million. Efforts to reduce the number of children in foster care will save \$5 million, and a 30-day waiting period prior to the issuance of the initial child care payment to eligible families will save \$10 million. Issuance of bonds for critical infrastructure improvement in university and community college classrooms, libraries and laboratories, will enable the state to reduce discretionary payments to higher education institutions by \$30 million.

### **A Balanced Approach to Solving the General Fund Problem**

(\$ in Millions)



The Governor recommends that some specialized activities, currently supported with general fund dollars, be supported with federal or state restricted funds, instead of general tax revenues. The budget includes \$52.5 million in such fund shifts. The Governor also recommends that liquor licensees pay a greater share of the regulatory costs of the Liquor Control Commission, thereby saving the general fund \$13 million. And, in order to protect critical Medicaid safety net services, the Governor recommends new Medicaid provider taxes to help offset Medicaid costs, while increasing payment rates to physicians and mental health providers.

The Governor's budget reduces the general fund subsidy to the School Aid Fund and continues revenue enhancements contained in the current budget. These revenue enhancements include \$10 million from increased escheats enforcement; \$10 million from the sale of state property; and \$11 million associated with continuing to shift a portion of the general sales tax from the Comprehensive Transportation Fund to the general fund. Other revenue adjustments include shifting a portion of the Agriculture Equine Industry Development Fund to the general fund.



## Tax Subsidies

Michigan's tax code contains 170 tax exemptions, or subsidies, which cost the state over \$29 billion per year. Tax expenditures are credits, deductions, and exemptions from existing state taxes. They often represent state spending made through the tax system, rather than through the traditional annual budget.

As recommended in *The Price of Government*, a thorough analysis of the tax expenditures should be a part of any budgeting for outcomes process. The Governor recommends that Michigan's budget process be reformed to annually reconsider the effectiveness of tax subsidies to determine if they are achieving their intended purpose, and if they are delivering results for citizens.

The Governor's fiscal year 2006 budget process included an examination and prioritization of direct budget expenditures, as well as tax expenditures. The Department of Treasury examined all tax expenditures and subsidies and divided them into two groups.

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*"Most strategic reviews focus on government programs. But government does its work through many other mechanisms, including tax breaks and subsidies. These are rarely examined, but they provide rich opportunities for savings. . . . Strategic reviews should reexamine all subsidies and tax breaks, to see if they are the least costly way to achieve the desired outcomes."*

**David Osborne and Peter Hutchinson, *The Price of Government*, 2004**

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1. The first group represents those tax credits, deductions, and expenditures that most closely resemble appropriations made through the tax system, rather than through the usual budget system. This group of tax subsidies was considered in more depth as part of the budgeting for outcomes process.<sup>4</sup>
2. The second group includes tax expenditures or credits that are an inherent part of the state's overall taxation system. For example, this second group includes tax expenditures directly related to constitutional requirements (e.g., the sales tax exemption for food and drugs), or other state or local tax laws (e.g., the homestead property tax credit, the exemption for income tax paid to another state), as well as tax expenditures related to the adoption of the federal adjusted gross income standard. This second group also includes tax exemptions created by the scope of existing law (e.g., sales tax on services). This second group of tax expenditures was not part of the budgeting for outcomes process.

Each of the tax expenditures in the first group was reviewed to determine the intent of the tax subsidy, and then assigned to the goal with which it was most closely aligned. A guidance team of key economic, tax, and budget advisors met and analyzed each tax subsidy against its intended purpose, as well as its contribution to the results that matter to the public. The Governor recommends the elimination of nine tax subsidies because these expenditures no longer reflect the highest priorities of Michigan citizens. The savings gained from eliminating this spending will be directed toward other high-priority areas. The elimination of these subsidies will save the general fund \$64 million, and the School Aid Fund \$48 million.

The Governor recommends that the following tax subsidies be eliminated:

- the reduced oil and gas severance tax rate for marginal wells;

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<sup>4</sup> See Appendix C for further description of all tax expenditures in Group 1.

- the use tax exemption for international and toll-free telephone calls;
- the sales and use tax exemption for interstate motor carriers;
- the personal property tax exemption for the lease of water softeners;
- the exemption of railroads from the utility property tax;
- the sales and use tax exemption for copyrighted motion pictures purchased or leased by movie theaters for public viewing;
- the deduction of oil and gas income from the personal income tax;
- the sales tax exemption for soft drinks and food sold from vending machines; and
- the sales tax exemption for sales in prison stores.

## FISCAL YEAR 2005

A special revenue estimating conference was convened in December 2004 to identify potential fiscal year 2005 revenue shortfalls. The December conference identified a revenue shortfall of \$355 million. In order to prevent automatic reductions in K-12 school payments, legislation was enacted transferring \$99.5 million from the general fund to the School Aid Fund. The effect of the transfer was to concentrate the entire budget problem in the state's general fund. On January 13, 2005, the consensus revenue estimating conference met again and reduced the projected 2005 revenue shortfall downward slightly to \$335 million. However, rising Medicaid caseloads necessitate a \$40 million supplemental appropriation, bringing the total current year problem to \$375 million.

This shortfall triggers the Constitutional requirement that the Governor submit a proposal to bring the budget into balance. That proposal is being presented today. The overall solution to the current year problem includes a mix of spending reductions, savings from administrative efficiencies, projected expenditure lapses, several small one-time revenue adjustments, and the use of reserves. The solutions require the approval of an Executive Order reduction by the Appropriations Committees and the passage of a supplemental bill by the Legislature.

Fiscal Year 2005 (\$ in millions)	
Projected Revenue Shortfall	\$335.0
Medicaid Supplemental	40.0
<b>Total Shortfall</b>	<b>\$375.0</b>
Solutions:	
Budget Stabilization Fund Withdrawal	\$67.8
Reverse GF Supplemental to SAF	99.5
Other Spending Reductions	123.7
Medicaid Benefits Trust Fund Withdrawal	25.9
Lapses	15.9
Fund Shifts	40.3
Revenue increases	2.5
<b>Total</b>	<b>375.6</b>

The Management and Budget Act<sup>5</sup> specifies the Executive Order procedures. The Governor must provide at least five days notice to the Appropriations Committee of the time and place for the Executive Order presentation. That notice was issued on February 4, 2005. Approval of the Executive Order requires a majority vote of each Appropriations Committee within ten days after presentation. If either committee disapproves the Executive Order, the Governor may issue another Executive Order within 30 days.

As noted, the December 2004 passage of a supplemental bill for the School Aid budget concentrated the entire \$375 million shortfall in the state's general fund. However, since December, three changes have affected the School Aid budget.

1. When the state's financial books were closed for fiscal year 2004, the School Aid Fund carried forward an unanticipated \$74 million.
2. The latest projections indicate that fewer pupils are attending K-12 schools this year than had been expected. Since School Aid payments are based upon the number of pupils in attendance, this change in pupils will reduce overall School Aid obligations.
3. The Governor is proposing a comprehensive reform of the School Bond Loan Fund, which will reduce School Aid Fund liabilities for both 2005 and 2006.

In the aggregate, these three factors have fully addressed the School Aid revenue shortfall, *without the need for the supplemental passed in December*. Therefore, as part of the overall solution to the current year problem, the Governor recommends that the supplemental be reversed, thereby restoring the funds to the general fund and making them available to help solve the \$375 million problem.

The remaining problem of \$275 million is addressed through \$124 million in spending cuts, \$40 million in expenditure shifts to restricted funds, \$16 million in known expenditure lapses. The spending cuts include \$60 million in agency administrative savings and \$18 million in Medicaid cuts. A change in the child care payment policy will save \$10 million in 2005. Higher education funding is reduced by \$30 million; however, all of this funding – and more – is replaced with \$100 million in bond proceeds for special maintenance at universities and community colleges.

The Governor also recommends the withdrawal of \$26 million from the Medicaid Benefits Trust Fund and \$74 million from the Budget Stabilization Fund. With these actions, the projected balance in the School Aid Fund at the end of fiscal year 2005 will be an estimated \$24 million. The balance in the Budget Stabilization Fund will be almost \$7.5 million.

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<sup>5</sup> P.A. 431 of 1984, as amended, MCL 18.1391

## Conclusion

While the process by which the Governor has developed her budget has changed, the priorities of the citizens and job providers of Michigan have not changed. We seek a lean government that offers critical services for the best price available. Job providers seek a competitive tax structure and a high quality of life – from a solid educational system to affordable health care to a wonderful place to work, play and raise your family.

Even during the most challenging of economic times, Governor Granholm's budget provides all of this, without raising general taxes. Because the budget relies on cuts instead of one-time fixes, it continues efforts to address the structural problems. Make no mistake about it; this was not an easy accomplishment. Governor Granholm made bold decisions to balance this budget – decisions that reduce funding for important initiatives. These decisions were made in order to promote economic growth and create a better Michigan.

We must not delay – we must act decisively now to get the jobs we need today and the jobs we need tomorrow. We can do it; we can grow Michigan together – starting with this balanced budget.